

June 19, 2006

**AGENDA ITEM 9a**

**TO: MEMBERS OF THE INVESTMENT COMMITTEE**

- I. SUBJECT:** Approval of Contracts for Asset Allocation Consultants
- II. PROGRAM:** Asset Allocation/Risk Management
- III. RECOMMENDATION:** Staff requests Investment Committee approval to exempt from competitive bidding and the Disabled Veteran Business Enterprise participation requirements the following contracts: Financial Engines Advisors L.L.C, EFI Actuaries and Towers Perrin.
- IV. ANALYSIS:**

**Background**

At the December 13, 2004 Investment Committee Meeting, the Board directed staff to conduct Asset/Liability Workshops every 3 years. The last Workshop was held in October of 2004 and the next Workshop is scheduled for the Fall of 2007.

**Financial Engines Advisors L.L.C. (FEA)**

CalPERS has utilized the services of Professor William F. Sharpe, an advisor with FEA, since the early 1990's. Dr. Sharpe, a Nobel Prize winner in Economic Sciences, has been a trusted and valued resource to CalPERS. He has provided CalPERS with detailed style and implied expected excess return analyses for the various asset pools that comprise the Public Employees' Retirement Fund (PERF). Dr. Sharpe developed the optimization program used by staff to select asset mixes for further analysis as part of the Asset/Liability Workshop process. Dr. Sharpe uses his propriety software to calculate and provide data used in the optimization process. He has also been called upon to provide advice on various asset allocation issues and to participate as a panel member at the Asset/Liability Workshop.

In addition to services provided by Dr. Sharpe, FEA provides a quarterly Style and Performance Analysis Report on each of the PERF accounts.

#### EFI Actuaries (EFI)

Since 1996, EFI has provided the Board and staff with liability statistics and software models for CalPERS' State, Schools, and Public Agencies for use in preparing for the CalPERS Asset/Liability Workshops. These models are proprietary to EFI and are used to stress test Decision Factors utilized in the asset allocation process. In addition, these models are used to perform a global search for an optimal portfolio based on a set of Decision Factors and weights.

EFI was selected on November 22, 1996, as part of a Request for Information (RFI) competitive selection process in which 10 organizations submitted proposals. Presenters were evaluated on their knowledge of asset and/or liability modeling, the reasonableness of the fee, and the availability of modeling software from the firm. EFI was selected following the interview process that included the Chief Investment Officer, Chief Actuary, Dr. Sharpe, and the CalPERS senior level investment staff.

#### Towers Perrin

CalPERS entered into a contract with Towers Perrin through the same RFI process detailed above. They produce Monte Carlo simulation results. These results are provided to EFI Actuaries to use in the PERF simulation model. Towers Perrin customizes their model to create output data (5,000 scenarios, 25 years for inflation, yield and asset return data) and creates files for transmittal to CalPERS and EFI Actuaries.

Towers Perrin has participated in several CalPERS' Asset/Allocation Workshops and is uniquely qualified since they have done extensive research and testing to develop U.S. Capital Market Simulations and assumptions for asset/liability forecasting.

#### **Criteria for Exemption from Competitive Bidding**

This exemption is requested pursuant to Board Resolution No. 92-04B-2, based upon the following criteria:

It is necessary to meet the fiduciary duties of the Board **AND** the following criteria applies:

The work to be performed is extremely sensitive; and the work involves critical timeframes; and failed performance of the work would result in dire consequences to the System; and there is a known entity that is capable of performing the work correctly and expeditiously; and the known entity can perform the work for a reasonable fee.

As described above, several requirements must be met in order for the Board to approve an exemption from competitive bidding. Staff believe the requirements of the criteria are met by the actions described below.

### **Sensitivity of Work**

#### **Financial Engines Advisors L.L.C.**

Dr. Sharpe provides for the critical conversion of the complex liability data received from EFI simulations into "liability returns" that is used as input for the surplus optimization procedure. This is accomplished by analyzing the worksheets that resulted from the projections made by Towers Perrin and EFI. It is this step that importantly integrates the assets and liabilities customized for CalPERS. FEA is a trusted partner with CalPERS in the keeping and care of this data.

#### **EFI**

The models used in the Asset/Liability Workshop are comprised of confidential member and CalPERS' liability data, thus the nature of this work is extremely sensitive. EFI is a trusted partner with CalPERS in the keeping and care of this data.

### **Critical Timeframe**

The process of updating and validating the liability and asset models in preparation for the Workshop normally takes up to 18 months to complete (See Attachment 1- Draft of 2007 Asset/Liability Management Workshop Timeline). The result of the Workshop will be an asset mix chosen by the Board. This asset mix will in turn affect the range of employer contribution rates for specific employer sub-groups and will factor into the employer contribution rate-setting process. This process is performed under Ron Seeling's direction on a fixed calendar and will commence following the Workshop. State and School rates are set at the May Board meeting. The public agencies rates are completed between July and October 31 of each year for the rate they are to pay beginning the following July 1. FEA, EFI and Towers Perrin are all integral parts of the process and will adhere to the timeline set by EFI (CalPERS' liability modeling consultant) for completing all of the work necessary in the appropriate amount of time to meet our actuary's needs.

In addition to this normal timeframe, and beginning no later than July 1, 2006, EFI will test the effect of recent changes in CalPERS' actuarial assumptions (e.g. 15 year smoothing of asset gains and losses; 30 year amortization of the unfunded actuarial accrued liability in an attempt to stabilize employer contribution rates) on our Decision Factors to ensure there will be no detrimental effect on them.

### **Consequences of Failed Performance**

The construction and validation of the resultant CalPERS' asset mix model must be completed in time for the Asset/Liability Workshop in the Fall of 2007. This will allow the Chief Actuary's group sufficient lead time to consider the ramifications of the asset mix selection on the rate-setting process. For example, a move to a very conservative asset mix would imply a low expected return. This in turn would suggest the need for a higher contribution rate.

### **Basis for Selection**

FEA, EFI and Towers Perrin have historical relationships with CalPERS. FEA has a proven competence and track record for the timely completion of projects. The Workshop is dependent on Dr. Sharpe's ability to provide the set of inputs and the optimization program used by CalPERS' staff to select candidate asset mixes for further analysis. There is no other firm or consultant, in our opinion, that has a better understanding of the complexities of CalPERS' assets/liabilities and who can provide the optimizer necessary for this process. EFI's relationship with CalPERS has been to provide the construction of liability models and to act as the third-party auditor. They have a proven competence and track record for the timely completion of projects. The Workshop is dependent on EFI's ability to provide the liability modeling work required. There is no other firm in our opinion that understands the complexities of CalPERS' liabilities as well as EFI, or who has the modeling capabilities necessary for this process. Towers Perrin has consistently provided Staff with asset and economic variable forecast scenario simulations. All three contractors work together to provide a cohesive and successful Asset/Liability Workshop.

### **Reasonable Fee**

The fee for the services to be performed by each contractor is as follows:

The fee for FEA is \$100,000 annually. FEA has charged the same annual fee for these services since 1990 when they began providing the quarterly analyses reports. There is no additional charge for Professor Sharpe's work on the Asset/Liability Workshop.

The fee for EFI is \$275,000 and is considered fair and reasonable based on charges for previous workshops for comparable actuarial and asset/liability consulting services. The \$275,000 is a 10% increase from the \$250,000 fee charged for the previous workshop held in October 2004. The \$250,000 fee is an 11% increase from the \$225,000 charged for the August 2002 workshop.

The fee for Towers Perrin is \$35,000 and has been consistent throughout the history of their engagements with CalPERS for similar work for both the Decision Factor Workshop and the Asset/Liability Workshops.

**Exemption from Disabled Veteran Business Enterprise Contract Participation Requirements (DVBE)**

An exemption from the DVBE contract participation requirements is warranted due to the proprietary nature of the work of all three contractors. The creation of inputs and the optimization process can only be performed expeditiously by FEA utilizing their proprietary software. The running of liability simulations, and the validation of the models, can only be performed expeditiously by EFI utilizing their proprietary software. The asset and economic variable forecast scenario simulations are created using a proprietary software model Towers Perrin has developed for CalPERS.

**V. STRATEGIC PLAN:**

Goal VII: Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.

**VI. RESULTS/COSTS:**

The approval of contracts with Financial Engines, EFI and Towers Perrin will maintain the continuity and integrity of the Asset/Liability Workshops that are provided for the CalPERS Board. These three contractors play an integral role in assisting staff in obtaining the goals of (1) ensuring that sufficient assets are available for benefit payments; and (2) minimizing and stabilizing contribution rates as well as producing mixes that provide efficient results with respect to performance. Each firm will be awarded a contract for the maximum three (3) year term.

The annual cost for the services to be performed by each contractor is as follows:

- FEA - \$100,000
- EFI - \$275,000
- Towers Perrin - \$35,000

Total annual cost for Asset/Liability Workshop contracts - \$410,000

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